United States Court of Appeals

for the Second Circuit

APPELLANT'S REPLY BRIEF

74-2582

B

P/S

United States Court of Appeals

For the Second Circuit

Docket No. 74-2582

ROSALIND FOGEL, *et ano.*,

Plaintiffs-Appellants,

versus

GEORGE A. CHESTNUTT, JR., *et al.*,

Defendants-Appellees.

PLAINTIFFS-APPELLANTS' REPLY TO THE AMICUS BRIEF

POMERANTZ LEVY HAUDEK & BLOCK
Attorneys for Plaintiffs-Appellants
295 Madison Avenue
New York, New York 10017
(212) 532-4800

ABRAHAM L. POMERANTZ,
WILLIAM E. HAUDEK,
RICHARD M. MEYER,
DANIEL W. KRASNER,
Of Counsel.

5

TABLE OF CONTENTS

TABLE OF CASES

STATUTES AND REGULATIONS

AUTHORITIES

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

Docket No. 74-2582

ROSALIND FOGEL, et ano.,

Plaintiffs-Appellants,

versus

GEORGE A. CHESTNUTT, JR., et al.,

Defendants-Appellees.

PLAINTIFFS-APPELLANTS' REPLY
TO THE AMICUS BRIEF

By leave of Court, plaintiffs submit this brief in response to the Amicus brief of Lord, Abbett & Co.

POINT I

RECAPTURE THROUGH CREDITS AGAINST
THE FUND'S ADVISORY FEES WOULD
HAVE BEEN LAWFUL IN ALL RESPECTS.

The Amicus's principal point assumes, arguendo, that the Management Co. or a subsidiary thereof could properly have secured NASD membership or a seat on the PBW

Exchange (ABr 2).* On this assumption, we contend, the subsidiary could have received a share of the Fund's portfolio brokerage commissions; and the Management Co. could have deducted the amount of these commissions from the advisory fees payable by the Fund. According to the Amicus, this recapture method would have violated the anti-rebate rules** of the PBW and Pacific Coast Stock Exchanges as well as various statutes forbidding preferential or discriminatory practices.

The Amicus's argument rests on a fundamental error: It overlooks that, despite reduction or elimination of the advisory fees, the Fund would have paid the full minimum commissions, without any rebate or other diminution. The Fund would thus have fully complied with the anti-rebate rules and would not have received better treatment than any

---

*"ABr" means the Amicus Brief, "PMBr" means Plaintiffs' Main Brief.

**For convenience, we refer to the minimum commission and anti-rebate rules collectively as anti-rebate rules. Those of the PBW Exchange appear at 125a et seq., those of the Pacific Coast Exchange at ABr 4-5.

other customer paying the minimum commissions.

<u>No violation of the anti-
rebate rules.</u>

It is elementary that the minimum commissions prescribed by the stock exchange rules were designed to pay the broker not only for the execution of his customer's orders, but also for various collateral services, including, particularly, the giving of investment advice. As stated by the SEC in its <u>PPI Report</u>* (144a):

> "*** the level of the minimum commission rates of the national securities exchanges is affected by the fact that brokerage commissions compensate brokers not only for execution and clearing services but for investment advice and other services customarily provided without extra charge."

The commissions were, of course, <u>minimum</u> commissions; the brokers were free, therefore, if they chose (and if the customers agreed) to charge an advisory fee in addition to the commissions. So long as the brokers received the

---

*Securities and Exchange Commission, Report on the Public Policy Implications of Investment Company Growth, 89th Cong., 2d Sess., H.R. 2337 (1966).

minimum commissions, nothing in the anti-rebate rules either required or forbade an additional fee for advice.

Since it was a matter of indifference under the exchange rules whether the extra advisory fee was large or small or zero, the broker was also free to reduce the fee in proportion to the volume of the customer's commission business. In other words, he could reduce the fee by the amount of the commissions. This was frequent practice; see the SEC's <u>PPI Report</u> (143a-144a):

> "The use of brokerage commissions to pay for investment advisory services is common in the securities industry. Investment advisers who are also broker-dealers often reduce advisory fees charged nonfund clients by a specified portion of the brokerage commissions generated by their nonfund advisory accounts or otherwise take them into account in setting advisory fee rates for nonfund clients."

Nothing in this practice contravened the anti-rebate rules; for despite the reduction or even the elimination of the advisory fee, the customer still paid the prescribed minimum commission rates. The mathematical

operation of the practice is illustrated in the margin.*

An adviser of a mutual fund, upon securing regional exchange membership for itself or for its subsidiary, was in no different position. The adviser or its subsidiary could execute the fund's portfolio transactions at the prescribed minimum commission rates; or it could, as introducing broker, share the minimum commissions with an executing broker. In either case the adviser could lawfully reduce the fund's advisory fee by the amount of the commissions received. As shown, this was not a forbidden rebate; for while the fee was reduced or eliminated, the fund still paid the minimum commissions, and those included compensation for the investment advice given the fund.

---

*Suppose that, over a period of time, a customer had incurred minimum commissions of $100,000. His investment advisory fee for the same period was $120,000. If the fee was reduced by the amount of the commissions, the customer paid his broker a net amount of $120,000 ($100,000 as commissions and $20,000 as the balance of the fee). Since this was more than the minimum commissions, the anti-rebate rule was satisfied.

Or suppose that the minimum commissions were $100,000, while the advisory fee was only $80,000. If the commissions were applied against the advisory fee, the fee was eliminated; but the customer still had to pay the minimum commissions of $100,000. Again the anti-rebate rule was satisfied.

The same principle supported the propriety of recapture through membership in the NASD. The fund paid the prescribed minimum commissions to a PBW or Pacific broker executing its portfolio transactions. A subsidiary of the fund's adviser, having secured NASD membership, shared in these commissions through give-ups or discounts;* and the adviser reduced the fund's advisory fee by the amount of the give-ups or discounts. Since, as shown, this fee reduction was not a forbidden rebate, NASD recapture was wholly consistent with the anti-rebate rules.

The SEC's Institutional Investor Study Report (92nd Cong., 1st Sess., House Doc. 92-64 [1971]), vol. 4, pp. 2296-98, quoted in the margin,** confirms the practice and its legality.

---

*The abolition of "give-ups" on December 5, 1968 (333a) did not affect the propriety of "discounts". Give-ups went to firms that had nothing to do with the underlying securities transaction; whereas "discounts" went to an NASD member which introduced the transaction to an exchange broker.

**"(1) Investment adviser affiliates established by broker-dealers.- Many broker-dealers are also investment advisers or have established subsidiaries to manage investment companies and other types of accounts. These accounts are normally charged advisory fees separate from the commissions charged on the execution of orders for the account. Because stock exchange minimum

(Footnote continued on following page)

No discrimination.

Recapture did not constitute preferential discrimination in favor of mutual funds, forbidden by the Maloney Act,* the antitrust laws or other statutes. Even after

---

(Footnote continued from previous page)

commissions have been deemed by the exchanges to include compensation for investment advice these fees are often reduced by all or part of these commissions. The NYSE provides that advisory services 'may be furnished by the member or member organization ... to a non-member, either free of cost or on a fee basis. If such services are furnished on a fee basis, the fee may be adjusted in accordance with commission business received ... from the non-member.'

"* * * *

"(2) Broker-dealer affiliates established by investment advisers and other institutional investors.- In recent years a number of institutional investors have established brokerage affiliates that have joined exchanges and executed orders for the institution and others.

"In 1965 Waddell & Reed, Inc. an adviser managing $2 billion in mutual fund assets, formed a broker-dealer subsidiary, Kansas City Securities Corporation, which joined the Pacific Coast Stock Exchange (PCSE). Within the next year Kansas City was joined on that exchange by subsidiaries of three other mutual fund advisers. In each instance these advisers reduced the management fees of the funds under their management by part or all of the net profits earned by the member subsidiaries. Since then other investment advisers have formed broker-dealer affiliates which have joined regional exchanges, especially the PCSE and Philadelphia-Baltimore-Washington Stock Exchanges (PBW)." (Footnotes omitted)

*§ 15A(b)(8) of the Exchange Act, 15 USC § 78o-3(b)(8).

recapture, the funds did pay the minimum commissions. So did all other customers of stock exchange brokers. Recapture, to be sure, relieved the funds of the payment of an extra advisory fee; but other customers likewise received the investment advice of their brokers without any extra payment therefor. The minimum commission, as noted, included compensation for investment advice. Recapturing funds thus paid for investment advice through the minimum commissions. So did all other customers. Since all received equal treatment, there was no discrimination in favor of funds who recaptured through credits against their advisory fees.

The First Circuit sustained the legality of recapture, Moses v. Burgin, 445 F. 2d 369, 381-82 (1st Cir.), cert. denied, 404 U.S. 994 (1971). The SEC urged recapture. The PBW and Pacific Exchanges sanctioned it. The expert witnesses vouched for it. The Court below did not disagree; nor did any other court;* and several decisions, in addition to Moses, have forcefully approved recapture (PMBr 55-56). The Amicus is the lone dissenter.

*The Amicus's supposedly contrary authority, Robert W. Stark, Jr., Inc. v. New York Stock Exchange, 346 F. Supp. 217, 226 (S.D.N.Y.), aff'd on other grounds, 466 F. 2d 743 (2d Cir. 1972), did not involve recapture through credits against advisory fees.

The approval of recapture by the SEC.

The Amicus (ABr 14-15) would deprecate the SEC's advocacy of recapture in the PPI Report as "the weakest of dicta" because, so it says, the writer of the Report might not have considered the anti-rebate rules. Actually, however, the SEC deemed recapture sufficiently important to urge it twice, in the introductory part (141a) and again in the body of the Report (146a-147a). On both occasions the Report expresssly referred to "the existing commission rate structure", i.e., the system of minimum commission and anti-rebate rules. We quote:

> "Under existing commission rate structures, mutual fund shareholders could derive greater benefits from their brokerage commissions if the give-up portions of the commissions were transmitted to the funds themselves or their adviser-underwriters for the purpose of reducing management costs." (141a)

> "***Within the framework of the existing commission rate structure it [recapture] is a method whereby mutual fund shareholders can derive greater benefits than they have heretofore received from fund brokerage commissions." (147a)

> "***It would not be inconsistent with those rules [regional exchange rules] for dealer-distributed funds to direct give-ups to their adviser-underwriters, all of whom are NASD members, for the purpose of applying these give-ups to reduce the advisory fees payable by the funds." (147a)

More than a year after PPI, the SEC's Exchange Act Release No. 8239 of January 26, 1968 (252a) referred to "the rigid minimum commission rate structure" (253a) and then reiterated the last-quoted sentence from the PPI Report (259a). To make its point abundantly clear, the Commission recited at length a variety of recapture methods and concluded (255a):

> "Through this means, public shareholders of institutions can, within the framework of existing practices developed by the securities industry, recoup substantial amounts of commissions actually paid for the execution of their portfolio orders despite a rigid commission structure which does not otherwise permit the institution to benefit from the very substantial portfolio business it may have to dispense." (Emphasis added)

The Commission, fully aware of the anti-rebate rules, thus again urged recapture.

Almost three years after this Release, in December 1970 - long after the abolition of give-ups - the SEC reaffirmed the propriety and, indeed, the necessity of recapture; Matter of Provident Management Corp., '70-'71 CCH Fed. Sec. L. Rep. ¶ 77,937 (SEC, 12/1/70). There, one Porteous was president of a mutual fund; he was also the president and controlling stockholder of the adviser and underwriter of the fund. In 1966 Porteous acquired membership in the PBW Exchange "in order to enable Porteous & Co.,

of which Porteous was then sole owner, to 'recapture' part of the brokerage commissions resulting from Fund's portfolio transactions" (pp. 80,085-6). Porteous incurred severe criticism and discipline, not because he used his PBW membership for recapture, but because he recaptured for himself rather than for the fund, whose fiduciary he was (pp. 80,086-7).* The Commission required Porteous to surrender to the fund the commissions he had received; the fund thus effected full recapture.

---

* "Porteous and Lautsbaugh, as officers of the Fund and as persons responsible for directing the execution of its portfolio transactions, and Management, by virtue of its position as investment adviser, were fiduciaries of Fund. As such, they were under a duty to act solely in the best interests of Fund and its shareholders. The payments received by Porteous & Co. from the Dackerman and Newburger firms under the guise of 'clearance commissions' did not represent compensation for any benefit conferred by it on Fund or for any function performed in connection with transactions on the PBW, but in substance represented reimbursement of a part of the commissions generated by the execution of Fund portfolio transactions directed to those firms. Porteous & Co. retained in their entirety the amounts which it recaptured, in addition to the management fees received by its affiliate. While there is no proof that Fund did not receive the best execution on its transactions, or that the existence of the arrangements described resulted in additional costs to Fund, once the reciprocal arrangements were made, it was improper for Porteous & Co. to keep for itself rather than confer on Fund the benefits attributable to Fund's assets."

Provident Management Corp., supra, at 80,086-7.

As late as April 1973 - after the SEC's public policy statement invoked by the Court below - the SEC reaffirmed and expanded the recapture rule of Provident Management Corp.; see Exchange Act Release No. 10102 of April 12, 1973 ('73 CCH Fed. Sec. L. Rep. ¶ 79,327).

The Amicus's attempts to minimize the SEC's deliberate and repeated statements and rulings in favor of recapture are thus ill conceived.

The approval of recapture by the PBW and Pacific Exchanges.

Equally misplaced are the Amicus's attacks (ABr 7-8) upon the interpretation of the PBW and Pacific Exchange rules by the Exchanges themselves. Mr. Wetherill, the president of PBW, and Mr. Phelan, the president of the Pacific Exchange, both testified that the Exchanges interpreted their rules as permitting recapture through credits against advisory fees (51a-53a, 218a, 220a, 224a-225a). As we have shown, this was, to say the least, a permissible interpretation of the exchange rules; it is, therefore, entitled to controlling weight, Moses, supra, 445 F. 2d at 382; see PMBr 64-65. Contrary to the Amicus, there was no need for a new exchange rule permitting recapture since the existing rules granted that permission.

The Amicus argues (ABr 8) that only the boards of governors of the Exchanges could interpret the Exchange rules and that the record does not show such board interpretation. We disagree. The recapture practices on PBW and Pacific continued openly over a number of years and cannot have escaped the attention of the boards of governors; if the boards did not expressly approve, their acquiescence was certainly approval by implication.* What is more, the power of interpretation did not rest exclusively with the boards of governors. The presidents of the two Exchanges were charged with the "duty to enforce the provisions of the Constitution and Rules"**(PMBr 64). The power to enforce necessarily included

---

* Since the Amicus is a defendant in Papilsky v. Berndt (ABr 2), it knows Mr. Wetherill's testimony that the PBW board of governors actually approved the interpretation permitting recapture (Papilsky Trial Transcript pp. 83-84). With respect to the Pacific Exchange, Mr. Phelan testified on deposition (Papilsky Trial Exh. 136, p. 18) that the Pacific board of governors knew of Phelan's letter to Caleb Loring of July 25, 1968 (224a; Papilsky Exh. 46) and did not object to it.

** Pacific Const. Art. III, § 4(b):

> "The President shall be the principal executive officer of the Exchange, and it shall be his duty to enforce the provisions of the Constitution and Rules and to foster the general interests of the Exchange."

PBW Const. Art. VII, § 1:

> "The President shall be the principal executive officer of the Exchange ***. He shall have care of the interests of the Exchange and shall be responsible for the management and administration of its affairs. It shall be his duty to uphold and enforce the Constitution and Rules of the Exchange."

the power to interpret; and the presidents' interpretation approving recapture is not shown to have been overruled by the boards.

The legality of the recapture of tender offer fees.

Defendants repeatedly directed Fund-generated tender offer fees to brokers who had assisted in the sale of Fund shares or had provided helpful information (deposition of defendant Greene, Exh. 26, pp. 97-98*). The recapture of these tender offer fees (discussed at PMBr 40) was, according to the Amicus (ABr 22), forbidden by Art. III, § 24 of the NASD Fair Practice Rules, presumably because such recapture would constitute the passing of an "allowance" to the Fund. Obviously, however, the "selling concessions, discounts, or other allowances" forbidden by the NASD rule (ABr 22) were similar to the "rebate, return, discount or allowance" prohibited by the analogous PBW and Pacific Exchange rules (125a; ABr 4). Since, as shown, credits against the Fund's advisory fees were not "rebates" or "allowances" within the meaning of the Exchange rules, they were clearly not "allowances" within the meaning of the corresponding NASD rule.

Such was also the view of the SEC; Exchange Act Release No. 10102 of April 12, 1973 ('73 CCH Fed. Sec. L. Rep. ¶ 79,327):

---

* These pages are set forth in the Second Supplementary Appendix annexed to this brief.

" *** directors and managers of investment companies are reminded that they may have an obligation to name an affiliate broker to receive commission or solicitation fees and that where this is done, such commission or fees on the tender offer portfolio securities of the fund should not be retained by the affiliate but should inure to the benefit of the Fund."

A few months prior to this Release, the SEC had proposed a Rule which, if adopted, might have forbidden the recapture of tender offer fees; see Exchange Act Release No. 9920 of December 27, 1972 ('72-'73 CCH Fed. Sec. L. Rep. ¶ 79,156). The very fact that the SEC proposed such a rule demonstrates that, in the absence of an express prohibition, the Commission considered the recapture of tender offer fees as altogether lawful. Release No. 10102 withdrew the proposed Rule and reconfirmed the legality of recapture.*

The Amicus's authorities.

The Amicus (ABr 9-12) would analogize the anti-rebate provisions of the stock exchange rules to those of the Interstate Commerce Act, 49 USC §§ 2, 10, the Elkins Act, 49 USC § 41, and the New York Insurance Law, §§ 188, 209, 273 (McKinney's 1966).

---

* The Amicus (ABr 22-23) invokes a provision of the Williams Act, now § 14(d)(7) of the Exchange Act, 15 USC § 78n(d)(7), which in effect prevents a tender offeror from varying or increasing the tender price in favor of individual security holders. The provision is inapposite here since a reduction of the fund's advisory fees is a matter between the fund and its adviser and does not increase or vary the tender price.

See, e.g., Union Pacific R. Co. v. U.S., 313 U.S. 450 (1941); Baltimore & Ohio R. Co. v. U.S., 305 U.S. 507 (1939); Arcim Corp. v. Pink, 253 App. Div. 428, 2 N.Y.S. 2d 709 (3d Dept.1938), aff'd, 280 N.Y. 721, 21 N.E. 2d 313 (1939). The analogy is misplaced.

Under the federal statutes cited, a common carrier must not reduce his tariff charges by allowing the shipper a rebate. We assume that it might be a forbidden rebate for the carrier to allow free nontransportation services (e.g., free advertising) to the shipper, for the carrier's tariff charges are not designed to pay for services of that kind. Similarly, the New York Insurance Law prohibits an insurer or insurance broker to grant the insured a rebate from the premium specified in the policy. Again, the rendition of free noninsurance services (e.g., free advertising) might be an improper rebate since the insurance premium is not designed to pay for such services. By contrast, the minimum commission prescribed by the stock exchange rules is designed to pay the broker for giving investment advice to his customer (p. 3, above). It follows that the rendition of investment advice, free of extra charge, is not an improper rebate.

The introducing broker.

According to the Amicus (ABr 18-20), it would have been unlawful for a subsidiary of the Management Co. to become an

introducing broker on the PBW Exchange and, as such, to recapture commissions for the Fund. The argument is in direct conflict with the testimony of Mr. Wetherill, the president of PBW. Here, as elsewhere, the Amicus would have it that this experienced official did not know what he was talking about under oath.

In major part, the Amicus's argument - its insistent reference to the introducing broker as a "dummy" - is epithetical rhetoric. In fact, the introducing broker performs important, indeed, essential brokerage functions. In the first place, it has the customer - not an unimportant ingredient of the brokerage business. Another crucial brokerage function is the rendition of investment advice; the introducing broker, directly or through its affiliate, gives that advice to its customer. The selection of the best possible executing broker is another task of the introducing broker; that is likewise a brokerage function. Compared with these difficult tasks, the execution of an order is comparatively mechanical; defendants themselves so admit (Def. Br. 11-12). The market place has evaluated the relative importance of the introducing and executing brokers; ordinarily they divide the commission in the proportion of 80% to the introducing broker and 20% to the executing broker (60a). It is thus simply fatuous to call the introducing broker a "dummy".

The Amicus (ABr 19) invokes Art. XIV, § 2 of the PBW Constitution*, which provides that "[o]nly a corporation whose principal corporate purpose is the transaction of business as a broker or dealer in securities" may become a member of PBW. Since the introducing broker's principal corporate purpose is, indeed, the transaction of business as a securities broker, we fail to see the Amicus's point (see also PMBr 28-30). In any event, the interpretation by the PBW of its own Constitution is a permissible one and has, therefore, "controlling weight", Udall v. Tallman, 380 U.S. 1, 16-17 (1965).

Nor is it necessary for an introducing broker on the PBW to have more than one customer or to deal with the general public (Wetherill 57a). But even if there were such a requirement, the Management Co. would meet it since it does "manage many millions of dollars in hundreds of individual accounts" (Def. Br. 23-24 n.). See also defendant Greene's testimony that he "effected transactions" not only for the Fund but also for "the other advisory clients of the Chestnutt Corporation" (104a).

The SEC has repeatedly recognized the legitimacy of introducing brokers. Its Report of Special Study of Securities Markets (88th Cong., 1st Sess., House Doc. 95 [1963], Part 2, p. 297, refers to "[m]ember firms without execution and clearance

---

* The Amicus (ABr 19) erroneously cites Art. XIII, § 2 of the PBW By-laws.

facilities [which] must channel their Exchange orders through New York member firms possessing them." The SEC's Exchange Act Release No. 8746 of November 10, 1969 ('69-'70 CCH Fed. Sec. L. Rep. ¶ 77,761) refers with approval to recapture arrangements "where the affiliate on the exchange does not execute or clear transactions for the account of the fund, but merely receives revenue from other brokers, which revenue is attributable to transactions executed for the account of the fund by such other brokers." In Matter of Provident Management Corp., supra, '70-'71 CCH Fed. Sec. L. Rep. ¶ 77,937, an affiliate of a fund's adviser-underwriter had secured PBW membership "in order to enable [the affiliate] to 'recapture' part of the brokerage commissions resulting from the Fund's portfolio transactions" (pp. 8085-6); the SEC not only permitted but required the recapture of the commissions by the fund. For a similar introducing brokerage arrangement on the Pacific Exchange, see The Financing of Sales of Mutual Fund Shares, 115 U. Pa. L. Rev. 769, 832-3 (1967).

The supposed legal dangers of recapture.

The Amicus (ABr 24-33) recites a catalogue of the "possible ways" in which recapture might have caused legal problems for the Fund or the Management Co.: The Fund's contracts with its brokers or with the Management Co. "might" have been

unenforceable (ABr 28); the Fund and the Management Co. "might" be subject to damage liability under the Exchange Act (ABr 26), the Sherman Act (ABr 29) and, "conceivabl[y]", the Robinson-Patman Act (ABr 32); or they might have suffered in other "unpredictable ways" (ABr 33).

To begin with, no such issue has been raised by defendants, either in the trial court (see the pretrial order, 25a *et seq*.) or in this Court. It is not for an amicus to raise completely new issues at the close of the appeal stage.

In any event, the Amicus's argument has no merit whatever. The Amicus does not contend that any of the supposed dangers was a reality. Numerous funds and their advisers did engage in recapture over a period of almost ten years. The Amicus does not assert that any claim of the sort it hypothesizes was ever asserted, let alone sustained, against any of these organizations.

The thrust of the Amicus's argument seems to suggest that the supposed dangers might have induced the directors of the Fund to forego recapture. The answer is simple. Not one word in the record suggests that the directors gave the slightest consideration to the supposed dangers. An independent board, properly advised, might arguably have decided, as a matter of business judgment, that the risks of recapture outweighed the

advantages of recapture.* But the directors never exercised a business judgment of the sort suggested by the Amicus. The business judgment rule does not apply to a judgment that conceivably might have been but actually never was exercised.

It is hardly necessary to add that the dangers of recapture apprehended by the Amicus are imaginary. Apart from other fallacies, there could be no violation of the Exchange Act or the antitrust laws unless recapture was a discriminatory rebate. Since, as we have shown, it was not, the argumentative edifice of the Amicus collapses.**

---

* Since the charter of the Fund made recapture mandatory (PMBr 24, and pp. 22-26, below), there was actually no room for the exercise of such a business judgment.

** Similar defense arguments were rejected by the First Circuit in Moses v. Burgin, supra, 445 F. 2d at 381-2, n. 19.

POINT II

UNDER THE CHARTER OF THE FUND, IT WAS DEFENDANTS' DUTY TO EFFECT RECAPTURE. DEFENDANTS' VIOLATION OF DUTY IS NOT EXCUSED BY THE SUPPOSED EXERCISE OF BUSINESS JUDGMENT.

The charter.

The charter of the Fund forbade it to sell its shares at a price which, after deduction of any load or commission for the distribution of the shares, would yield to the Fund less than their net asset value.* This provision was violated if the Fund received asset value for its shares but compensated the selling broker by paying it a reward out of recapturable portfolio commissions. As was held in Moses, supra, 445 F. 2d at 374:

> "If Fund receives the asset value of new shares, but at the same time rewards the selling broker with give-ups that it has a right to recapture for itself, then the net income Fund receives from the process of selling a share is less than asset value.*** Such application violated its

*The relevant charter provision, ¶ 3(c)(iv), appears at PMBr 24 and at p. 351a of the Supplementary Appendix, annexed to plaintiff's main brief.

[Fund's] charter if it would have been practicable to obtain the give-ups for the direct benefit of its treasury."

Since, as we have shown, various recapture methods were "practicable", it was defendants' duty to utilize them.*

1. The Amicus argues (ABr 39) that the Fund's opportunity to recapture its portfolio commissions was not an asset in the accounting sense, so that recapturable commissions did not have to be included in the Fund's balance sheet. We fail to see the relevance of this observation. If a broker sold shares of the Fund for $100 (that amount representing the properly computed balance sheet asset value), the Fund should have received that $100 net and clear of sales commissions. If, instead, defendants caused the Fund to pay that broker a two dollar commission out of moneys the Fund could otherwise have recaptured, the net proceeds from the sale of the shares, after deduction of commissions, were only $98. Had the two dollars been recaptured, they would have been shown as an asset in the

*As shown in our previous briefs, the duty also arose from defendants' position as fiduciaries. Since the Amicus does not address that point, there is no occasion to discuss it here.

Fund's balance sheet. The loss of the two dollars was thus real in every sense, practical, accounting and balance sheet - as much so as if the Fund had paid the two dollars out of its treasury.

2. The Amicus (ABr 40) imputes to us a contention that the Fund could not incur sales expenses such as printing prospectuses or registering its shares. We never made such a claim. The charter required the Fund to receive the net asset value of its shares "after deduction of [any] load or commission". It contained no comparable provision dealing with the expenses of printing and registration.

3. The Amicus finally argues (ABr 40-41) that plaintiffs and other shareholders of the Fund are estopped from relying on the charter; for, says the Amicus, they profited from the charter violation in that the price they paid for their shares was based on a balance sheet that did not include recapturable commissions. The argument cannot be quite serious.

(a) Throughout the period in which recapture was possible, the Fund never did recapture so much as a dime. It would have taken temerity for defendants to divert the Fund's recapturable commissions for their own benefit and, at the same

time, to include the recapturable commissions, as an "asset", in the price at which they sold the shares of the Fund to the public.

(b) Recapture practices began to be availed of in 1965 (11a). Plaintiffs became stockholders of the Fund before that time (26a, 325a); so did many others. Even on the Amicus's theory, plaintiffs and these other stockholders paid full value for their shares. On no conceivable ground can they be deemed to be estopped.

(c) The claim in suit belongs to the Fund, not to its stockholders. The Amicus offers no ground supporting an estoppel of the Fund.

(d) Even on the violent assumption that a stockholder who purchased his shares, say, in 1967, paid less for them than the charter required, estoppel does not follow. After all, it was defendants who determined, from day to day, the asset value of the shares of the Fund. A purchaser of the shares had no way to check the accuracy of the computation. It would be a parody on justice to disfranchise such a stockholder by denying him the right to complain of later charter violations by the management of the Fund.

4. The authorities cited by the Amicus (ABr 42) for a restrictive reading of Moses v. Burgin, supra, are not in point. None of them purported to deal with a charter provision such as that involved here and in Moses.

Business judgment.

The Amicus seems to contend (ABr 35-39) that, despite the charter, the directors of the Fund could forego recapture in the exercise of business judgment. Plainly, however, the directors could exercise their business judgment only within the confines of the charter.* Moses, supra, so held (445 F. 2d at 374):

> "We cannot, therefore, consider absolving the defendants, if we find that they have violated any duty owed the Fund [under the charter], by finding that directing give-ups to brokers benefitted Fund by stimulating sales of its shares." (Interpolation added)

In any event, there is not a shred of evidence that the

*The statements of Mr. Budge, Mr. Loomis and Mr. Casey, quoted by the Amicus (ABr 36-39), do not consider the effect of a charter provision such as that here involved. Nor do the quoted statements consider the possibility of using a brokerage affiliate that would act merely as an introducing broker.

board of directors of the Fund, in the exercise of business judgment, decided to forego recapture. Indeed, it is undisputed that "[t]here are no writings reflecting any discussions or deliberations by any of the Fund's directors with respect to recapture" (31a). Since recapture could have yielded large savings to the Fund, any board decision not to recapture would doubtless have been recorded in the minutes. In the absence of such a record, defendants cannot be heard to invoke _ex post facto_ rationalizations as a substitute for the business judgment which the board failed to exercise; see _Winkelman v. General Motors Corp._, 44 F. Supp. 960, 973-4 (S.D.N.Y. 1942):

> "Directors and officers who pay themselves large sums out of the corporate treasury for some extraordinary purpose should see to it that they are formally authorized to make the payment, if they expect to justify it at some future date. They make the record of what they do at the time it is done and the record should be specific, complete and unambiguous, where their interests conflict with those of the Corporation."

Moreover, it is difficult to see any scope for the supposed exercise of business judgment. Defendants' only argument against recapture is their alleged opposition to "the Adviser's entering into the brokerage business with the necessary diversion of effort, talent and resources to a new

and different business and the conflict of interest inherent in self-dealing" (34a). None of these arguments applies, however, to the use of a Management Co. subsidiary as "introducing broker", which would merely have continued doing what the Management Co. was doing in any case. With the brokerage objection and the supposed illegality of recapture out of the way, the directors would have been quite willing to embrace recapture (120a-121a).

POINT III

THE ADVICE OF COUNSEL DEFENSE HAS NO MERIT

1. It is undisputed that Mr. Sabel and Mr. Lee (the two attorneys on whose advice defendants claim to have relied) were subject to serious conflicts of interest. Both had substantial stock interests in the Management Co., Sabel 16%, Lee 1% (26a-27a). Both were officers and/or directors and counsel of the Management Co. (27a-29a). Since the interests of the Fund and the Management Co. in the availability of recapture were diametrically opposed, neither Mr. Sabel nor Mr. Lee could give disinterested advice on the issue.

The Amicus (ABr 33-34) contends, nevertheless, that defendants were entitled to rely on these biased advisers. The law is otherwise. In Shushan v. U.S., 117 F. 2d 110, 118 (5th

Cir.), cert. denied, 313 U.S. 574 (1941), the court rejected the defense because the lawyer who rendered the advice was the defendant's partner, entitled to share in his profits -

> "and not a lawyer who had no interest save to give sound advice for a reasonable fee; ***."

Accord: U.S. v. Piepgrass, 425 F. 2d 194, 198 (9th Cir. 1970):

> "It has been recognized that the interested attorney may be influenced, albeit honestly, by his personal interests."

See Comment, Reliance on Advice of Counsel, 70 Yale L.J. 978, 983 (1961):

> "If an attorney stands to realize appreciable personal benefits from the adoption of a particular plan of action by his client, his interest may well influence his opinion on that plan's legality. This problem arises frequently in the corporate context. For example, if an option plan bestows stock of considerable value upon the corporation's general counsel, directors may not be justified in relying on his advice that the plan is lawful."

Contrary to the Amicus's assertion, the authorities it cites (ABr 33-34) did not involve the advice of adversely interested counsel. In the one case constituting a possible exception, Blaustein v. Pan American Pet. T. Co., 293 N.Y. 281, 300, 56 N.E. 2d 705, 713 (1944), the lawyer advising the directors of a corporation was also counsel to its adversely interested parent. The lawyer did not, however, have a pecuniary interest in the

parent; and while the directors of the subsidiary had no choice but to accept the lawyer's advice temporarily*, they pr otly proceeded to secure the advice of independent outside unsel. This, of course, is precisely what the present defendants should have done but failed to do (121a, 321a).

2. The circumstances of the present case, ignored by the Amicus, made it altogether inexcusable for defendants to abide by the self-serving advice of Messrs. Sabel and Lee.

Since early 1965, several large fund organizations were engaging in recapture to the tune of millions of dollars annually (29a-30a; Pl. Reply Br. 14). These recapture practices received wide publicity (30a) and were known to the Management Co. defendants (PMBr 21). In 1966, and repeatedly thereafter, the SEC sustained the legality of recapture and urged that recapture would be in the interest of the fund stockholders. The PBW and Pacific Exchanges, as well as the NASD, permitted and, indeed, facilitated recapture. In the face of this weighty body of aw and experience, it was irresponsible for defendants blithely to accept the contrary views of self-interested counsel;

---

* The lawyer advised the subsidiary's directors that the acquisition of oil properties in Mexico would violate the Mexican antitrust laws. The directors necessarily postponed the acquisition pending the receipt of disinterested advice.

and to accept them without the benefit of a thorough investigation and persuasive reasoning.

There was no independent counsel; there was no such investigation and no such reasoning. So casual was the action of counsel that not a single piece of paper reflects their advice (272a). No board minutes of the Fund and no agenda of the board suggest that the board ever considered the legality of recapture (31a, 249a-250a). Indeed, none of the directors ever requested the advice of counsel on the subject (249a). Any discussion of the legal question was, at best, informal, haphazard and "in the context of our over-all business" (249a-250a). This is not the type of "legal advice" on which directors should be permitted to rely at the expense of the fund whose interests it is their duty to protect.

The advice was not only casual but so patently untenable that any director familiar with the Fund's business must have perceived its lack of merit. Thus Sabel and Lee purported to distinguish the SEC's approval and recommendation of recapture on the ground that the Commission dealt with dealer-distributed funds, whereas the Fund was a no-load fund (30a, 271a-272a, 321a). The distinction was transparently meaningless. If recapture was feasible, the presence or absence of a sales load had nothing to do with it. Despite the absence of a sales

load, defendants did use broker-dealers to sell the shares of the Fund to the public (92a-93a, 322a-323a). It was these broker-dealers who received give-ups and reciprocals out of the Fund's portfolio commissions (ibid.). The Fund was thus no less "dealer-distributed" than the recapturing funds discussed by the SEC. Since the use of broker-dealers for the sale of Fund shares was revealed in the prospectuses and proxy statements (144a-177a), defendants had no right to rely on the contrary statements of Messrs. Sabel and Lee.

Equally far-fetched was counsel's statement that NASD membership was unobtainable because the Fund was a no-load fund (249a). The Fund did sell its shares through broker-dealers, as just shown; it could make no difference to the NASD whether these broker-dealers were paid out of a sales load or out of give-ups and reciprocals. In any event, a brief inquiry to the NASD would have revealed the availability of membership.

In Moses v. Burgin, supra, the SEC's repeated recapture urgings finally induced the defendants, in early 1968, to undertake a thorough investigation of the possibilities of recapture, including inquiries of the various regional exchanges and the NASD (445 F. 2d at 380). The present defendants did nothing of the sort. They did not consult independent counsel (121a, 321a). They did not even bother to seek information by a simple letter

or telephone call to the regional exchanges or the NASD (250a-251a).

We submit that, in the circumstances of this case, defendants' acceptance of the advice of their self-interested lawyers was nothing short of reckless. Certainly, it was not reasonable and should, therefore, afford no defense.

3. Even if the advice of counsel and defendants' reliance thereon had been reasonable, they would not shield defendants from liability for their profits. The advice of counsel, after all, is relevant only "as a circumstance indicating good faith"; Bisno v. U.S., 299 F. 2d 711, 719 (9th Cir. 1961), cert. denied, 370 U.S. 952 (1962); Comment, supra, 70 Yale L.J. at 978, 979, 990. A claim for a fiduciary's profits does not depend upon negligence or bad faith, Restatement, Trusts 2d § 203 (1959):

> "The trustee is accountable for any profit made by him through or arising out of the administration of the trust, although the profit does not result from a breach of trust."

In Wilshire Oil Co. v. Riffe, 381 F. 2d 646, 651-52, (10th Cir.), cert. denied, 389 U.S. 822 (1967), and in Fleishhacker v. Blum, 109 F. 2d 543, 545-46 (9th Cir.), cert. denied, 311 U.S. 665 (1940), the defendant fiduciaries were held

to be liable for their profits regardless of good faith. In Winkelman v. General Motors Corp., 44 F. Supp. 960 (S.D.N.Y. 1942), the defendant Knudsen was held liable for an excessive "equalization payment" (a kind of bonus), "although he thought it was proper" and "felt that he had earned it" (pp. 976, 979). In Epstein v. Schenck, 35 N.Y.S. 2d 969 (S. Ct., N.Y. Co. 1939), corporate directors were required to repay excessive bonuses received by them although the court found them free of fraud or negligence (pp. 980-82).

By the same token, the Management Co. and its stockholders are liable for the profits and benefits they received* regardless of their claimed good faith. The alleged advice of counsel gives them, therefore, no defense.

CONCLUSION

Since this case has been fully tried on the issue of defendants' liability, we submit that this issue is ripe for

---

* The profits were substantial. Thus it was the Management Co.'s contractual duty to the Fund to compensate the broker-dealers who sold the shares of the Fund (169a, 183a; PMBr 57); it discharged that burden by compensating them out of the Fund's recapturable portfolio commissions. This practice also enhanced the size of the Fund and, with it, the amount of the advisory fee.

final determination by this Court. As we have shown, the grounds on which the District Court dismissed the action should be overruled. If that is done, the remaining issues are questions of law; a remand of these questions to the District Court would be pointless. The undisputed evidence plainly shows that the directors of the Fund never exercised their business judgment to forego recapture (pp. 26-28, above); and even if defendants' testimony concerning advice of counsel be accepted as true in all respects, defendants' liability is established. If findings of fact be deemed necessary, this Court can readily make them without the need of a remand, Chris Craft Industries, Inc. v. Piper Aircraft Corp., _______ F. 2d ____________, '74-'75 CCH Fed. Sec. L. Rep. ¶ 95,058 at p. 97,703 (2d Cir. 1975); Moses v. Burgin, supra, 445 F. 2d at 373, n. 6.

We submit, therefore, that the decision of the District Court should be reversed, that defendants should be found liable, and that the case should be remanded for a determination of the amount of recovery, including the Fund's damages and the defendants' profits.

DATED: New York, New York
October 6, 1975

Respectfully submitted,

POMERANTZ LEVY HAUDEK & BLOCK
Attorneys for Plaintiffs-Appellants
295 Madison Avenue
New York, New York 10017

ABRAHAM L. POMERANTZ,
WILLIAM E. HAUDEK,
RICHARD M. MEYER,
DANIEL W. KRASNER,

Of Counsel.

SECOND SUPPLEMENTAL APPENDIX

bill and deliver a certain amount of the stock to the purchaser. There are variations on a group purchase.

Q Do you have any recollection as to how often you would engage in these group purchases?

A Not very often. Most of the time we call the individual underwriters.

Q Do you recall, Mr. Greene, whether since you've been with American Investors Fund they've ever participated in a tender offer where the Fund has tendered stock?

A There have been a few occasions where the Fund has tendered stock pursuant to a tender offer.

Q On those occasions what broker or dealer would be designated to receive the tender offer fee?

A I don't know which one exactly would be--

Q What criteria would you use in designating the broker who would receive a tender offer?

A Well, generally we would designate a broker who we knew, who is known to us, who had been helpful or who had tried to be helpful, or one that had assisted in the sale of Fund shares. We didn't call up a perfect stranger and designate them.

Q In other words, you would designate a broker who either assisted in the sale of Fund shares or

provided what you would call helpful information?

A Yes.

Q Was there any general rule about which of these two categories you would usually use when designating a broker? You would try to designate brokers who assisted in the sale of Fund shares?

A We had no particular policy. Since this only happened maybe two or three times over the last seven or eight years, it's a very rare occasion.

Q Nevertheless tender offer fees can on occasion be very substantial, can't they?

A It depends on the amount of stock one owns and how much one wishes to tender, and the rate that the buyer is willing to pay.

Q You are aware of the fact, Mr. Greene, that the Securities and Exchange Commission has caused the New York Stock Exchange and the other stock exchanges to permit negotiation of brokerage commissions on transactions in excess of $300,000, is that correct?

A Yes.

Q Does the Fund in fact, negotiate on transactions in excess of $300,000?

A Of course.

Q Does the Fund have any specific policy with

Service of three (2) copies of the within is admitted this 8th day of October 1975

William C. Harvey

COPY RECEIVED

Time ____________

Date 10-8-75

ROGERS HOGE & HILLS
~~Attorneys for~~

____

2 COPY RECEIVED
10/8/75
ROGERS & WELLS
~~ATTORNEYS FOR~~

COPY RECEIVED

OCT 8 1975

DEWEY, BALLANTINE, BUSHBY, PALMER & WOOD
Attorneys For: Amican, Lee Albert